

May 20, 1997

FOMC Briefing
Donald L. Kohn

Again the Committee is faced with a decision about whether to tighten monetary policy. Data since the last meeting would only seem to have highlighted (1) the strength of aggregate demand, which was cited as reason for tightening in March, and the associated rise in resource utilization; and (2) questions about the relation of growth and resource utilization to inflation.

Items in the first category might be seen as supporting additional near-term firming of policy. Obviously, there's considerable uncertainty about the degree of labor market tightness that can be sustained over time. But, whatever the uncertainties, a falling unemployment rate heightens the risk that the economy is operating beyond its long-run potential, except in the unlikely event that fundamental supply and demand determinants in labor markets are evolving continuously to moderate cost increases.

The Committee would not have to be so concerned with assessing whether the unemployment rate has slipped to below full employment if it were confident that the stance of policy was already sufficiently restrictive to keep the economy close to its potential. In this circumstance, any increase in inflation would be quite limited. In fact, real interest rates are now at, or above, levels that in the past 20 or 30 years have been consistent with containing inflation. Although interest rates

are about unchanged over the intermeeting period, this does not imply that your tightening had no effect on credit markets; most of it had already been priced in. Relative to just before the Chairman's Humphrey-Hawkins testimony, yields still are up about a quarter point or so.

Nonetheless, in the staff forecast they are not high enough and inflation trends higher; stated another way, the "equilibrium" interest rates implied by that forecast are appreciably above historical averages of real rates, and policy is still accommodative. This judgment is consistent with the observation that intermediate- and long-term rates around current levels over the past year have been associated with robust growth over subsequent quarters that, judging from the unemployment rate, has permitted the economy to run above its estimated potential.

Mike gave several reasons why current rates may not be providing sufficient restraint; I'll add a few more. One is the persistent strength in profits. This strength suggests an abundance of highly productive investment opportunities. Although such investment increases the economy's potential over an extended period, in the short run the demand for capital goods tends to put pressure on the economy's ability to supply such goods, driving up prices. In effect, the higher marginal product of capital needs to be matched with higher interest rates to keep savings and investment in balance. Another, longer run, reason why equilibrium real rates might creep up over time is the evolution of financial markets. A wider variety of sources of

funds for borrowers implies fewer nonprice constraints on credit, and more pressure on prices--that is, interest rates--to ration scarce savings. This is an ongoing process; a recent example is the securitization of commercial real estate loans, which is reducing dependence on traditional lenders, and helping to finance the recovery in this area.

If you share the staff forecast perspective that the current unemployment rate is probably too low to be consistent with containing inflation and that financial conditions are probably insufficiently restrictive to bring the economy back to a sustainable level, then tightening would seem to be called for before too long. Prompt action, at this meeting might appear justified if you were determined to head off any possible increase in inflation and wanted to lean in the direction of bringing it down over the long run. Immediate firming might also be appealing if you shared Mike's view that the risks were tilted toward higher utilization than in the Greenbook forecast, and you wanted to have greater assurance of avoiding more abrupt and possibly disruptive tightening later.

Tightening would come as some surprise to the markets, but an outsized reaction to a 1/4 point move would be unlikely. Developments over the recent intermeeting period would seem to suggest a considerable--and perhaps not entirely desirable--market resiliency to policy firming. Against the background of the announcement in March together with more rapid first-quarter GDP growth than most had anticipated and a falling unemployment

rate, the markets would see such an action as a logical extension of the Committee's last move. However, because growth is perceived to be slowing, the Committee likely would be interpreted as being especially attentive to the level of the unemployment rate.

Some of the recent data, on the other hand, would seem to lend support to arguments for standing pat now and adopting a cautious approach to any further tightening. The economy does seem to be slowing, holding out the hope that resource utilization rates may stabilize. In this regard, the current circumstances differ from those facing the Committee at its last meeting, when the pace of economic expansion was clearly exceeding the growth of potential. In addition, cost and price increases have remained remarkably restrained, which, as noted, have underlined uncertainties about the inflation process. In the staff forecast, with the output gap constant and inflation damped for a time, costs in terms of higher inflation of waiting for a short while are not large, and the Committee may view the staff as possibly unduly pessimistic about price prospects. Moreover, there are costs to tightening in the form of lower output and employment, if such an action turns out to be unnecessary to contain inflation; in this latter circumstance, though, additional progress toward price stability enhancing longer-term economic efficiency would presumably balance those costs.

One reason the costs of waiting should not be large, even if underlying inflation is about to edge higher, is that inflation

expectations should remain damped on either Wall Street or Main Street. Although most economists working for financial firms believe that tightening is necessary to contain inflation and will be forthcoming, this perception does not seem to pervade markets. The structure of short-term rates indicates only modest odds on a tightening at this meeting. Moreover, the overall slope of the yield curve is close to its historic average, suggesting that little, if any, upward movement of rates is seen as necessary to keep inflation from strengthening over the longer haul. On Main Street, damped increases in broad price indexes, helped by food and energy prices and by the past appreciation in the dollar, should hold down inflation expectations. Perhaps for these reasons, Michigan survey results show slightly lower mean inflation expectations in recent months, though the medians haven't changed much.

Even if the risks are seen to be tilted toward higher inflation, not moving at the current meeting would be consistent with a strategy that dealt with this possibility, but contemplated an especially deliberate pace of tightening. Such a strategy might seem a reasonable approach in a situation in which the Committee has said that it does not view policy as substantially misaligned, and in which evidence of actual cost and price pressures is sparse. Caution might also be engendered by tightening based almost entirely on projected inflation outcomes, when projections of inflation over recent years--including, it now seems likely, those by Committee members last February--have

often turned out to have been too pessimistic. This approach would gradually reduce possible inflation risks while allowing the accretion of additional information that might begin to resolve some of the uncertainties about the underlying inflation process.

One danger with such an approach is that policy becomes too sluggish--that it tends to be immobilized by uncertainties and proceeds so slowly that inflation pressures do in fact build. If the Committee chooses to keep policy unchanged at this meeting, it might want to be especially flexible in reacting to incoming news. In these circumstances, an asymmetrical directive would appear to be appropriate, clarifying the Committee's perception of the risks and signaling its willingness to move promptly should the odds on higher inflation become larger. Under some circumstances, a flexible policy response also may need to be a larger policy response over time. Catching up if inflation pressures become more evident or resource use rises further is likely to involve a larger increase in rates than a successful preemptive policy.

If the Committee adopts alternative B and an asymmetric directive, it might also find it useful to consider what kinds of information it would look for to trigger a tightening--if not before July, then at a scheduled meeting over the next few months. Presumably, the failure of the economy to slow enough to keep resource utilization rates from continuously rising further would signal an unsustainable situation that would prompt action,

whatever the news on costs and prices. This circumstance would be similar to the one the Committee faced in March--but now at a lower unemployment rate.

The more difficult circumstance would be one in which economic growth slows but only to around the rate of potential so labor markets retain their current degree of tautness, but costs, prices, and inflation expectations remain quiescent for a time. The policy decision would involve a weighing of where the Committee saw the risks and how it wished to weigh the potential costs and benefits of possible outcomes. If the Committee thought that the economic environment might have changed sufficiently in recent years to undermine its confidence in estimates of unemployment rate-NAIRU gaps or the inflation consequences of those gaps, it presumably would avoid tightening until it saw more definitive signs that inflation was in the process of picking up. This strategy would enable the economy to enjoy the output fruits of its changing dynamics, and might even be consistent with lower inflation as well, if indeed it is a "new age". On the other hand, if the Committee still had some conviction about the sustainable level of the unemployment rate, and that level was thought to be above the current level, however uncertain the Committee might be about the exact specification, then further, perhaps cautious, tightening might be called for even before higher inflation turned up in the data. Assuming the Committee would not want to countenance a more rapid rate of inflation, delaying action until prices accelerated under these

conditions would result in policy accentuating, rather than damping, the business cycle.